FIGURES

CHAPTER I. INTRODUCTION AND OVERVIEW

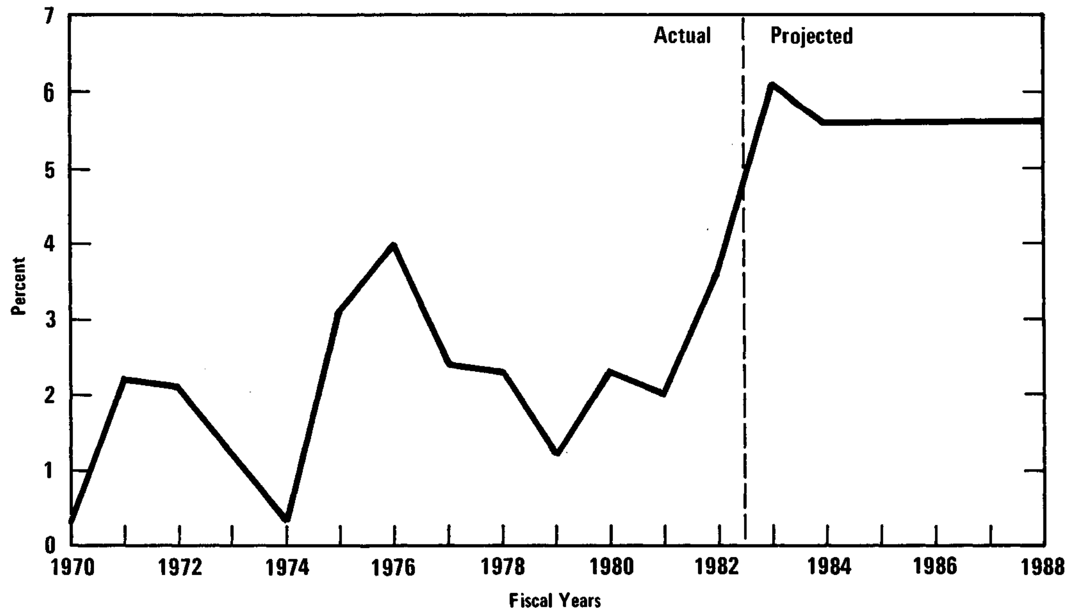
The American economy faces unprecedented risks in the years ahead unless the federal government takes measures to narrow the gap between tax revenues and spending. The Congressional Budget Office (CBO) has projected outlays and revenues in coming years, assuming no changes in current laws and policies. These "baseline" projections show federal deficits increasing from $194 billion in 1983 to $267 billion by 1988 (see Table I-1).

Even when gauged in relation to a growing gross national product (GNP), the size of these deficits is startling. For 1983 and 1984, CBO projects postwar record deficits amounting to 6.1 and 5.6 percent of GNP, respectively (see Figure I-1). To a great extent, these near-term deficits are attributable to the economic recession, which has reduced federal revenues and increased federal outlays for unemployment compensation and other income maintenance programs. But even as these cyclical causes wither as economic recovery proceeds, the projected deficits remain at the high level of 5.6 percent of GNP throughout the 1984-1988 period. This indicates a long-term mismatch between federal spending and taxing.

TABLE I-1. BASELINE BUDGET PROJECTIONS

	Actual			Estimated	Baseline Projection				
	1980	1981	1982	1983	1984	1985	1986	1987	1988
				In Billions of Dollars					
Outlays	577	657	728	800	850	929	999	1,072	1,145
Revenues	517	599	618	606	653	715	768	822	878
Deficit	60	58	111	194	197	214	231	250	267
				As a Percent of GNP					
Revenues	20.1	20.9	20.4	19.0	18.7	18.7	18.5	18.4	18.3
Outlays	22.5	22.9	24.0	25.0	24.3	24.3	24.1	24.0	23.9
Deficit	2.1	2.0	3.6	6.1	5.6	5.6	5.6	5.6	5.6

Figure I-1.
Federal Deficit as a Percentage of GNP



This budget outlook is based on CBO's most recent economic forecast for 1983-1984 and on what are believed to be reasonable assumptions for ensuing years. Real economic growth is expected to resume at a moderate pace in 1983, lowering the unemployment rate to 7.6 percent by 1988. Inflation is expected to continue to recede and to stabilize at around 4 percent a year (see Table I-2 and Figure I-2). 1/

STRUCTURAL DEFICITS AND THEIR CONSEQUENCES

The prospect of continuing large federal deficits even after five years of economic recovery is cause for alarm. In a deep recession, the growth of federal debt is usually funded in the capital market from savings that have no other outlet because business, consumer credit, and mortgage demands are at a low level. But as the economy recovers, private demands for credit will increase, leading to competition for funds between federal and private borrowers. Since total credit in the economy tends to remain at a fairly

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1. For further discussion see Congressional Budget Office, The Outlook for Economic Recovery (February 1983), Chapter III, and Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983), Chapter II.

Figure I-2.
Major Economic Assumptions

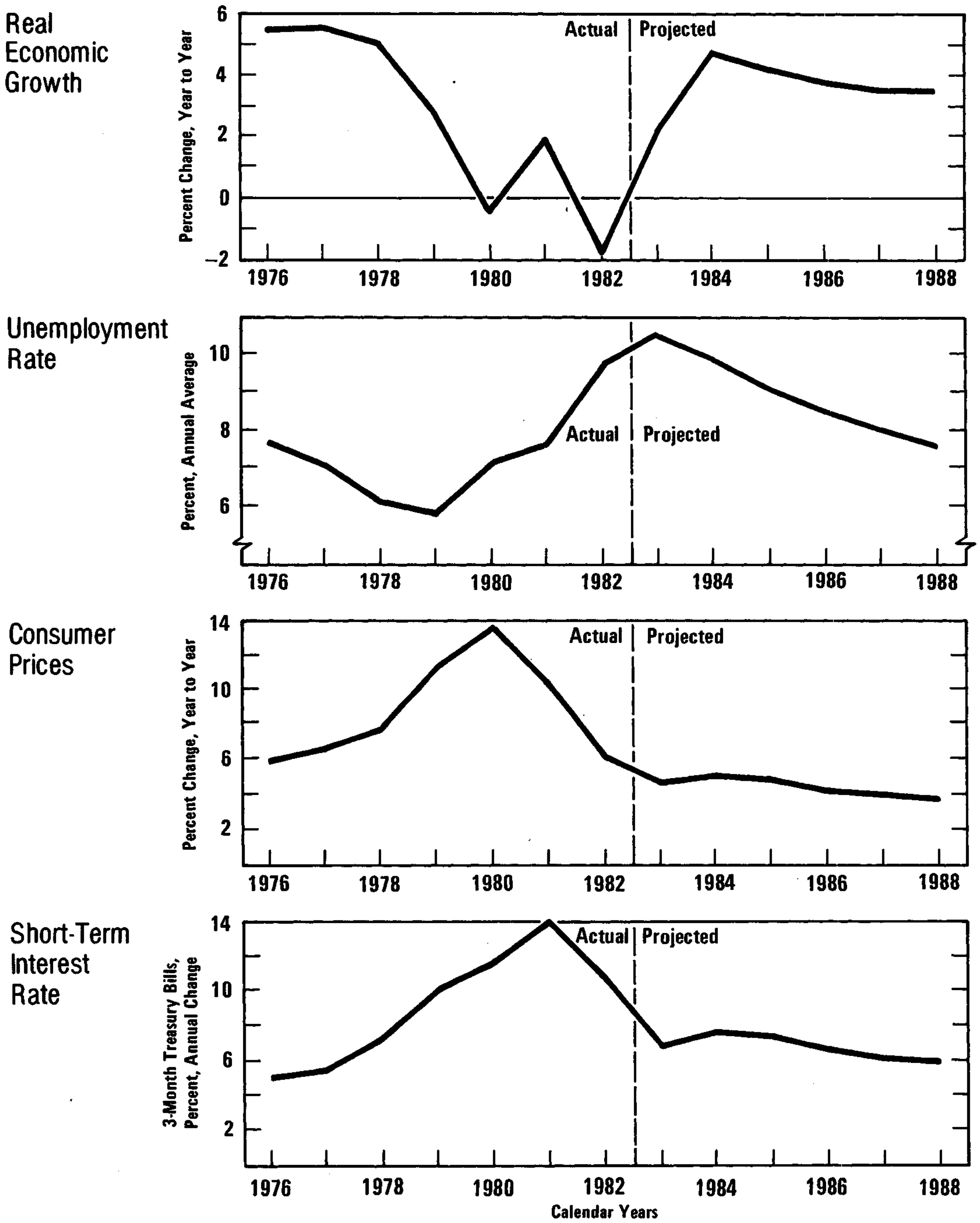


TABLE I-2. BASELINE ECONOMIC FORECAST AND ASSUMPTIONS

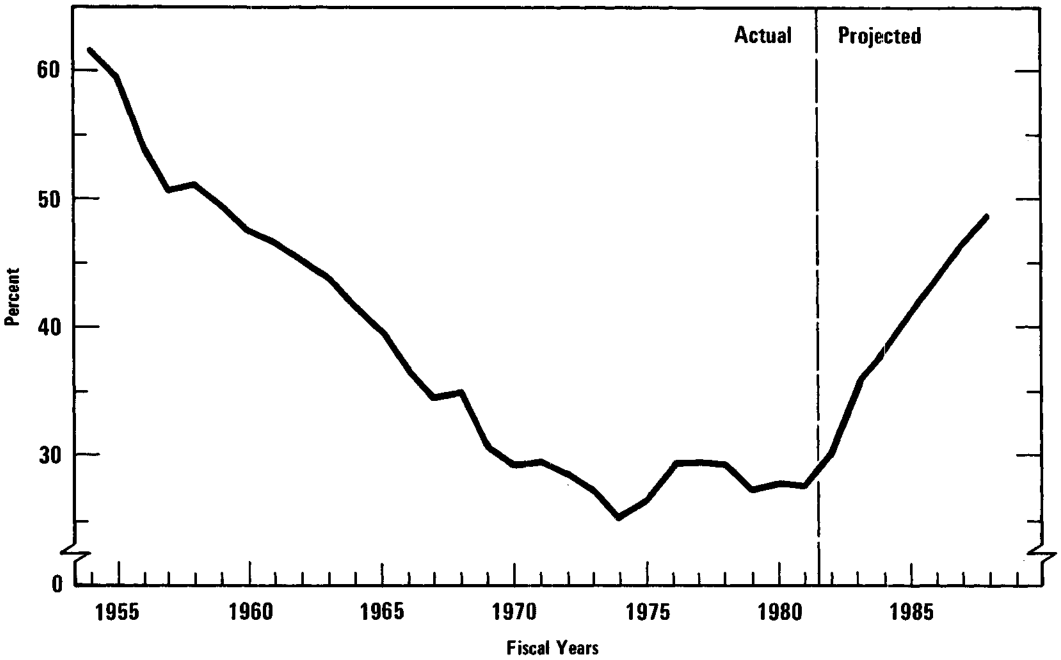
Economic Variable	1982	1983	1984	1988
		Fiscal Year Average		
Nominal GNP (billions of dollars)	3,033	3,197	3,499	4,792
Real GNP (billions of 1972 dollars)	1,480	1,492	1,559	1,808
Unemployment Rate (percent)	9.1	10.7	10.1	7.6
Interest Rate (91-day Treasury bills, percent)	11.6	7.0	7.3	5.9
		Percent Change, Fourth Quarter to Fourth Quarter a/		
Nominal GNP	3.3	8.9	9.6	7.9 b/
Real GNP	-1.2	4.0	4.7	3.6 b/
GNP Deflator	4.6	4.7	4.6	4.1 b/
Consumer Price Index	4.5	4.8	4.8	4.0 b/

a/ Fourth quarter of the calendar year.

b/ Average over four years ending in fourth quarter of 1988.

steady percentage of GNP, any increase in the ratio of federal debt to GNP threatens to "crowd out" other credit claimants. Intense competition for loanable funds would drive up real interest rates and increase the risk of aborting economic recovery. Even if the recovery continued, high interest rates would discourage the business investment in plant and equipment regarded as vital to improvements in productivity and economic growth. The projection of large government deficits in a period of economic recovery suggests that too small a share of GNP may be left for private investment, thereby limiting future standards of living and American competitiveness in the world economy.

Figure I-3.
Federal Debt Held by the Public as a Percentage of GNP



The CBO baseline projections show the magnitude of the increasing draft on credit markets implicit in current budget policy (see Table I-3). Federal borrowing to finance the deficit--and to finance the spending of off-budget entities, mostly credit institutions that lend to on-budget agencies--is projected to remain about 6 percent of GNP during the next five years (about double the average percent in 1975-1979, another recovery period). This level of borrowing means that the federal debt held by the public will grow faster than GNP, rising from 31 percent of GNP in 1982 to 50 percent by the end of 1988 (see Figure I-3). By contrast, the debt-to-GNP ratio fell steadily from the end of World War II to the early 1970s and remained level over the decade of the 1970s. The last time the ratio was 50 percent was 1959. The projection of a rising trend of federal debt in relation to GNP implies that nonfederal borrowers will have less access to capital. A budget policy conducive to private investment would show precisely the opposite trend.

HOW BIG IS THE PROBLEM?

There is no agreement about exactly how sensitive investment-related borrowing is to federal deficits. Economists have attempted to develop

TABLE I-3. FEDERAL BORROWING AND DEBT

	1982	1983	1984	1985	1986	1987	1988
			In Billions of Dollars				
Unified Budget Deficit	111	194	197	214	231	250	267
Off-Budget Deficit	17	17	15	16	19	17	17
Total Deficit	128	210	212	231	250	267	284
Other Means of Financing a/	7	-11	--	--	--	--	--
Borrowing from the Public	135	199	212	231	250	267	284
			As a Percent of GNP				
Borrowing from the Public	4.5	6.3	6.1	6.0	6.0	6.0	5.9
Federal Debt Held by the Public (end of year)	30.6	35.3	38.3	41.1	43.9	46.8	49.5

NOTE: Details may not add to total because of rounding.

a. Change in monetary assets and other adjustments.

guidelines for budget policy based on a variety of criteria--such as preventing increases in the ratio of federal debt to GNP, freezing the level of the inflation-adjusted debt, and limiting federal deficits computed at a standardized rate of employment. The economic rationales for some of these alternatives are discussed in a companion report. 2/ Broadly, the guidelines suggest that the cumulative reduction in federal debt over the 1984-1988 period should be in the range of $400 billion to $1,000 billion, or that the reduction of the deficit in 1988 from the projected baseline level should be on the order of $100 billion to $200 billion. Reaching these objectives would reduce the 1988 deficit from the projected $267 billion to between $50 billion and $150 billion, and would curb the increase in the ratio of debt outstanding to GNP.

2. See CBO, The Outlook for Economic Recovery, Chapter IV.

A simple way to grasp the dimensions of the budget problem is as follows. In 1988, a year in which unemployment is expected to average 7.6 percent, CBO projects the federal deficit at 5.6 percent of GNP. The last year in which unemployment was roughly comparable was 1981, when it averaged 7.4 percent. In that year, the deficit represented only 2.0 percent of GNP. Thus, between 1981 and 1988--two years of roughly comparable employment rates--the deficit is expected to rise by 3.6 percentage points of GNP. This increase, not related to the business cycle and thus "structural," amounts to about $170 billion at projected 1988 GNP. As noted, other guidelines for reducing the deficit might be chosen, but the $170 billion figure is near the middle of the range cited above. If the projected deficit in 1988 were reduced by $170 billion, it would total about $100 billion, or 2 percent of GNP.

POTENTIAL SOURCES OF DEFICIT REDUCTIONS

Finding $170 billion in deficit-reducing measures by 1988 will not be easy. The annual rate of the domestic budget cuts in the first year of the Reagan Administration was about $40 billion, and the hard-fought tax increases of the second year realized an average annual gain of about $33 billion. To achieve an even more ambitious deficit reduction goal will require reconsidering all parts of the budget and the tax base. Any reduction in spending will be perceived as entailing losses to some groups and will therefore involve difficult political choices. To clarify these choices, this section summarizes the composition of the current budget as it has evolved and as it will evolve in coming years if tax and spending policies are not changed. 3/

Federal spending can be divided in different ways. Congressional budget resolutions, for example, break down the budget into 19 functional categories such as health and transportation. But an overview of the budget is made easier by grouping programs into five categories: national defense, entitlement and other mandatory spending programs, nondefense discretionary spending, net interest, and offsetting receipts. Those program categories are described in the box on page 8

Federal Spending, 1965-1980. Between 1965 and 1980, total outlays rose from 18 percent to 22.5 percent of GNP (see Table I-4). Entitlements and other mandatory programs--largely Social Security, Medicare, Medicaid, and other benefits--advanced even more sharply, rising from 5 percent of

3. For a more detailed discussion, see CBO, Baseline Budget Projections for Fiscal Years 1984-1988.

FEDERAL BUDGET CATEGORIES

National Defense. Outlays for military and civilian personnel, operating costs, major weapons procurement, and military retirement benefits. Military and civilian workers' pay increases are included in the projections. (Chapter II)

Entitlements and Other Mandatory Spending. Programs in which spending is governed by a law making all who meet their requirements eligible to receive payments. Subcategories are:

> **Social Security.** Old-age, survivors, and disability benefits only. Medicare is in the next category and administrative expenses are in the nondefense discretionary category. (Chapter III)
>
> **Medicare and Medicaid.** Does not include state share of Medicaid expenditures. Federal administrative expenses for Medicare are in the nondefense discretionary category. (Chapter IV)
>
> **Farm Price Supports.** All outlays of the Commodity Credit Corporation for farm price support and related programs. (Chapter VI)
>
> **Other Entitlements.** Entitlements and other mandatory spending not included above or in "Net Interest." Major examples are Aid to Families with Dependent Children, Black Lung compensation, railroad retirement, federal civilian employee retirement, Guaranteed Student Loans, human services block grants, Supplemental Security Income, unemployment compensation, veterans' compensation and pensions, and General Revenue Sharing. The Food Stamp program has also been included in this category. (Chapter V)

Nondefense Discretionary Spending. All nondefense programs for which spending is determined by annual appropriations. The basic governmental legislative, judicial, and tax-collecting functions are included. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of government. Most grants to state and local governments (other than for benefit payments), nondefense research and development, and loans subject to appropriation limits are also in this category. (Chapters VII, VIII)

Net Interest. Interest payments on the federal debt less interest received by trust funds.

Offsetting Receipts. Proprietary receipts from the public and the employer share of employee retirement. Other receipts (for example, foreign military sales, trust fund receipts, and payments to trust funds) appropriately netted against outlays are included in the relevant categories above. (Chapter IX)

TABLE I-4. COMPOSITION OF FEDERAL SPENDING, 1965-1980

Category	1965	1970	1975	1980
	As a Percent of GNP			
National Defense	7.2	8.1	5.8	5.3
Entitlements and Other Mandatory Spending				
Social Security benefits	2.6	3.0	4.2	4.5
Medicare and Medicaid	a/	1.0	1.5	1.9
Farm price supports	0.4	0.4	b/	0.1
Other entitlements	2.1	2.2	4.5	4.0
Subtotal	5.2	6.7	10.2	10.5
Nondefense Discretionary Spending	4.7	4.5	5.1	5.5
Net Interest	1.3	1.5	1.6	2.0
Offsetting Receipts	-0.5	-0.6	-0.8	-0.8
Total	18.0	20.2	21.9	22.5
	As a Percent of Total Outlays			
National Defense	40.1	40.2	26.4	23.6
Entitlements and Other Mandatory Spending				
Social Security benefits	14.4	15.0	19.3	20.1
Medicare and Medicaid	a/	5.1	6.6	8.4
Farm price supports	2.3	1.9	0.2	0.5
Other entitlements	12.2	11.1	20.5	17.6
Subtotal	28.9	33.1	46.6	46.6
Nondefense Discretionary Spending	26.4	22.3	23.4	24.5
Net Interest	7.3	7.4	7.2	9.1
Offsetting Receipts	-2.5	-2.9	-3.5	-3.7
Total	100.0	100.0	100.0	100.0

NOTE: Details may not add to totals because of rounding.

a. Predecessor programs counted in other entitlements.
b. Less than 0.1 percent.

GNP to over 10 percent (see Figure I-4). The sharpest increases in this part of the budget occurred in the early 1970s as the result of legislated increases in Social Security and the expansion or creation of such programs as Food Stamps, Medicare and Medicaid, Supplemental Security Income, and General Revenue Sharing. Significant growth also took place in the nondefense discretionary programs during this period, as many grant-in-aid programs were expanded and as federal employees' pay was raised to achieve parity with pay in the private sector.

Reductions in the share of GNP devoted to national defense offset about one-third of the growth in entitlement and nondefense discretionary programs. Except for an upward surge of spending for the Vietnam War in the late 1960s, national defense outlays continued a long-term decline that began after the Korean War (when defense outlays accounted for nearly two-thirds of federal spending) and lasted until 1980 (when the defense share fell to less than one-quarter of total outlays).

By the late 1970s, the growth of the GNP share of entitlements had slowed, and the continued growth of federal spending in relation to GNP during the latter half of the decade came from continued expansion of nondefense discretionary programs and higher net interest outlays. The expenditures for interest were driven primarily by the large increases in interest rates of the period.

Federal Spending, 1980-1983. Recent budget trends point up the difficulty in containing federal spending. In just three years, from 1980 to 1983, federal outlays in relation to GNP rose another 2.5 percentage points--from 22.5 percent of GNP to 25.0 percent (see Table I-5). Each year set a new postwar high for federal spending in relation to GNP. The rise in spending is attributable to several factors. First, the long slide in defense spending relative to GNP was halted in the late 1970s; the defense share turned up sharply in the early 1980s. Second, the slower growth of entitlement programs in the late 1970s was reversed in the 1980-1983 period when indexation of these programs to the Consumer Price Index (or in the case of health programs, growth due to medical care inflation) caused an upsurge of spending that outstripped the growth of GNP. By 1983, unemployment compensation and other transfers that increase during recession, together with higher outlays for farm price supports, were also swelling the budget. Third, the share of spending for net interest rose sharply, not only because of higher interest rates but also because of rapid increases in the debt (caused by deficits both on- and off-budget). Finally, the recession and decline in inflation in 1982 and 1983 imposed a heavy drag on the growth of GNP, thereby raising the spending ratios.

Figure I-4.
Outlay Categories as Percentages of GNP

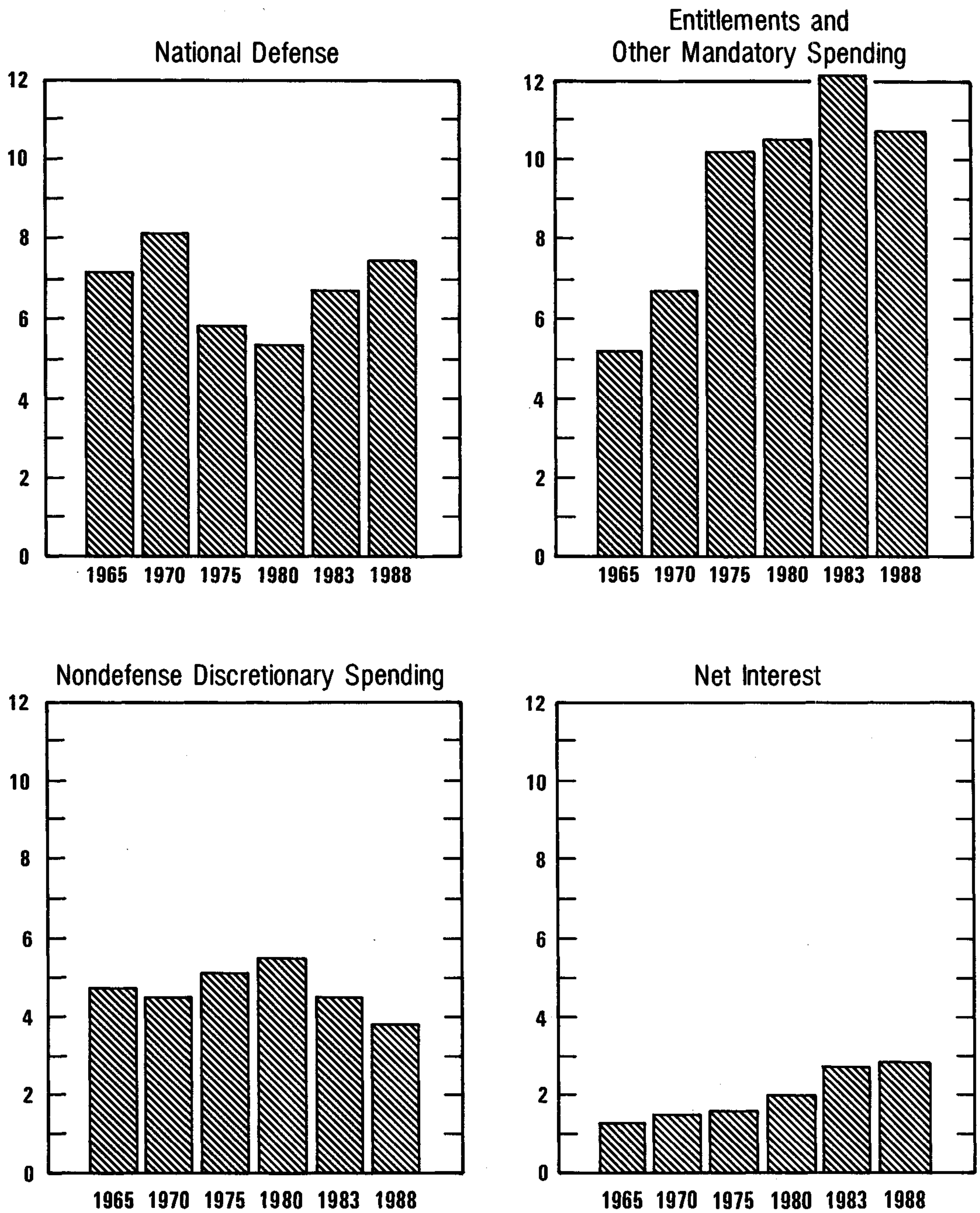


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TABLE I-5. COMPOSITION OF FEDERAL SPENDING, 1980-1988

Category	1980	1982	1983	1984	1988
			As a Percent of GNP		
National Defense	5.3	6.2	6.7	6.9	7.5
Entitlements and Other Mandatory Spending					
Social Security benefits	4.5	5.0	5.3	5.1	4.9
Medicare and Medicaid	1.9	2.2	2.4	2.4	3.0
Farm price supports	0.1	0.4	0.6	0.3	0.1
Other entitlements	4.0	3.7	3.9	3.4	2.7
Subtotal	10.5	11.4	12.1	11.2	10.7
Nondefense Discretionary Spending	5.5	4.6	4.5	4.4	3.8
Net Interest	2.0	2.8	2.7	2.7	2.8
Offsetting Receipts	-0.8	-0.9	-1.0	-1.0	-0.9
Total	22.5	24.0	25.0	24.3	23.9
			As a Percent of Total Outlays		
National Defense	23.6	25.7	26.7	28.5	31.3
Entitlements and Other Mandatory Spending					
Social Security benefits	20.1	21.0	21.0	21.1	20.3
Medicare and Medicaid	8.4	9.2	9.5	10.1	12.4
Farm price supports	0.5	1.6	2.2	1.1	0.4
Other entitlements	17.6	15.5	15.6	14.0	11.5
Subtotal	46.6	47.1	48.2	46.3	44.6
Nondefense Discretionary Spending	24.5	19.1	18.2	18.0	16.1
Net Interest	9.1	11.6	10.9	11.2	11.7
Offsetting Receipts	-3.7	-3.7	-4.0	-4.0	-3.6
Total	100.0	100.0	100.0	100.0	100.0

NOTE: Details may not add to totals because of rounding.

The only significant recent spending change countering this trend was an abrupt turnaround in nondefense discretionary outlays. By 1983, these programs were reduced to the place they had occupied relative to GNP in the early 1960s, before the growth of the Great Society programs. Caps on federal pay increases and a cessation of growth in grants to state and local governments contributed to the relative reduction in this category.

Baseline Projections, 1984-1988. Some of the recent trends are likely to continue in coming years, but others are not. CBO's baseline projections, which assume no further policy changes, imply that:

- National defense expenditures will continue to grow more rapidly than the rest of the budget and will constitute almost one-third of outlays by 1988.

- The extraordinary growth of net interest outlays will slow as the projected decline in interest rates offsets the projected rapid growth in debt outstanding. Nonetheless, at almost 12 percent of total outlays, interest payments will continue to be a major portion of federal spending.

- Entitlement spending in the aggregate will fall in relation to GNP (and as a share of total spending). In large measure, this decline reflects projected decreases in recession-related spending (unemployment compensation and farm price supports) and cuts in means-tested programs resulting from recent legislation. Spending on Medicare and Medicaid is projected to grow sharply as health-care prices continue to rise faster than prices in general. Social Security outlays should grow somewhat more slowly than GNP.

- Nondefense discretionary outlays are projected to become an ever-decreasing share of the total budget.

In dollar terms, these projections add $345 billion to federal outlays between 1983 and 1988. As the table on the following page shows, more than three-fourths of the projected outlay increase will be in the national defense and entitlements categories. Thus, any attempt to reduce outlays significantly as a major part of a $100 billion to $200 billion deficit reduction program will inevitably involve lower growth of spending in these two categories.

Change in Outlays, 1983-1988

	Billions of Dollars	Percent of Total
National Defense	144	42
Entitlements	125	36
Social Security	(64)	(18)
Medicare and Medicaid	(67)	(19)
Other	(-6)	(-2)
Nondefense Discretionary	39	11
Net Interest	47	14
Offsetting Receipts	-10	-3
Total	345	100

Approximately half of the projected $345 billion growth in federal spending represents inflation adjustments, not real growth. For nondefense discretionary programs, no real growth at all is assumed. 4/ In entitlement programs, real growth is assumed to occur only to the extent that current laws permit increases in the numbers of beneficiaries or in the use of services. In national defense programs, however, real growth is a major part of the $145 billion increase. These baseline defense projections, moreover, are based on targets in the budget resolution passed in 1982; the Administration's January 1983 budget proposal exceeds these targets.

Federal Revenues, 1965-1981. Two major trends are evident in the history of federal revenues between 1965 and 1981. First, social insurance (mainly Social Security payroll) taxes and corporate income taxes combined accounted for a remarkably stable share of all federal revenues, but payroll tax revenues rose sharply while corporate taxes fell (see Table I-6). These trends were attributable primarily to a declining share of corporate profits in national income, to legislated reductions in corporate taxes, and to a sharply increased fraction of wages and salaries subject to tax along with higher payroll tax rates. The rise in payroll taxes reflects the increases in Social Security and Medicare spending noted previously. Second, repeated cuts in individual income taxes held them below 9 percent of GNP except in 1969-1970, when an income tax surcharge was in effect, and again in 1980-1981. The 10 percent of GNP that went for individual income taxes in 1981 was the highest share since World War II. This record 1981 tax burden is

4. The basis for these projections assumptions is explained in CBO, Baseline Budget Projections for Fiscal Years 1984-1988.

TABLE I-6. FEDERAL REVENUES BY SOURCE, 1965-1981

Source	1965	1970	1975	1980	1981
			As a Percent of GNP		
Individual Income Taxes	7.4	9.3	8.3	9.5	10.0
Corporate Income Taxes	3.9	3.4	2.7	2.5	2.1
Social Insurance Taxes	3.4	4.6	5.7	6.1	6.4
Excise Taxes	2.2	1.6	1.1	0.9	1.4
All Other	0.9	1.0	1.0	1.0	1.0
Total	17.7	19.9	18.9	20.1	20.9
			As a Percent of Total Revenues		
Individual Income Taxes	41.8	46.9	43.9	47.2	47.7
Corporate Income Taxes	21.8	17.0	14.6	12.5	10.2
Social Insurance Taxes	19.1	23.0	30.3	30.5	30.5
Excise Taxes	12.5	8.1	5.9	4.7	6.8
All Other	4.9	4.9	5.4	5.0	4.8
Total	100.0	100.0	100.0	100.0	100.0

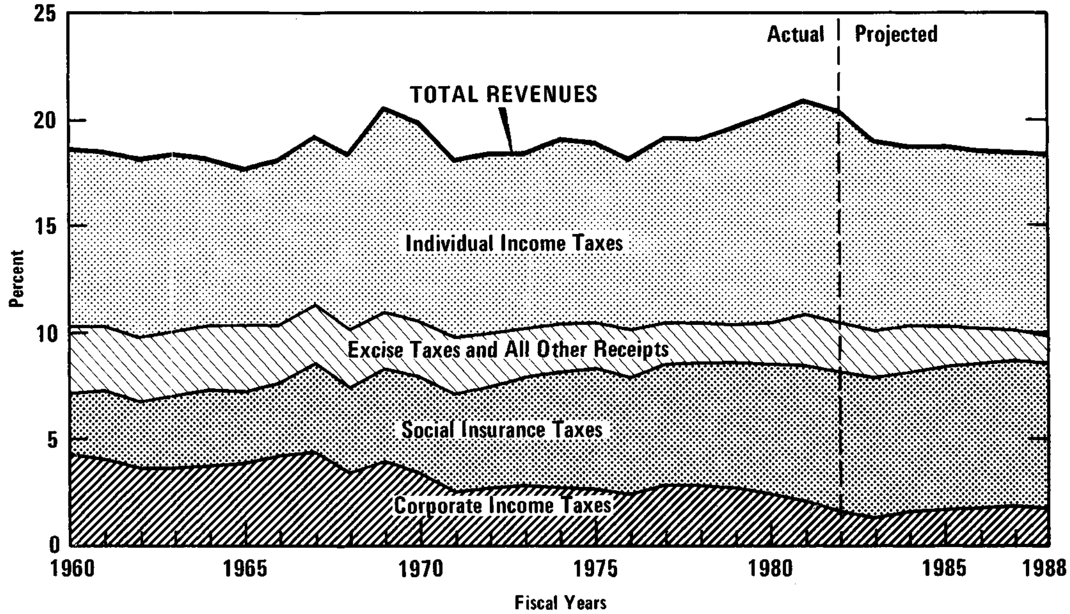
NOTE: Details may not add to totals because of rounding.

the major reason why total taxes as a share of GNP were 21 percent, the highest level in 35 years (see Figure I-5).

Federal Revenues, 1981-1988. In the 1981-1988 period, federal revenue projections show essentially a restoration of the tax burden that prevailed in the early 1970s (see Table I-7). Total revenues fall from 21 percent of GNP to nearly 18 percent. Payroll taxes continue to rise in importance, while excise and "all other" (customs duties and miscellaneous receipts) decline in importance. Most of the decline in the share of taxes in GNP is due to the fall in the ratio of personal income tax to GNP. This tax is projected to fall to 8.3 percent of GNP by 1988, the level it reached in the early 1970s.

Figure I-5.

Total Revenues as a Percent of GNP by Source, 1960-1988



The sharp reduction of the income tax burden in coming years is the result of the Economic Recovery Tax Act of 1981 (ERTA), which will reduce revenues by 1988, for example, by 5.6 percent of projected GNP (see Table I-7). Only a small fraction of the revenue loss under ERTA has been offset by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which concentrated most of its revenue gains in the corporate tax sector.

Accordingly, the baseline projections show what might be termed a 1975-style total tax take matched against a 1988 outlay projection featuring much higher spending for national defense, entitlement programs, and net interest. Had the tax legislation of 1981 and 1982 not been enacted (all else being equal), a large fraction of the projected deficits would not have appeared. But that would have required taxpayers to shoulder a tax load of nearly 23 percent of GNP, much more than in any postwar year.

TABLE I-7. FEDERAL REVENUES BY SOURCE, 1982-1988

Source	1982	1983	1984	1985	1986	1987	1988
				As a Percent of GNP			
Individual Income Taxes	9.8	8.9	8.4	8.4	8.3	8.3	8.3
Corporate Income Taxes	1.6	1.3	1.6	1.7	1.8	1.9	1.8
Social Insurance Taxes	6.6	6.6	6.6	6.8	6.8	6.8	6.8
Excise Taxes	1.2	1.2	1.2	1.1	0.9	0.8	0.7
All Other	1.1	1.0	0.9	0.8	0.6	0.6	0.6
Total	20.4	19.0	18.7	18.7	18.5	18.4	18.3
				As a Percent of Total Revenues			
Individual Income Taxes	48.3	47.2	45.1	44.9	45.0	45.2	45.5
Corporate Income Taxes	8.0	6.6	8.5	9.1	9.6	10.1	10.0
Social Insurance Taxes	32.6	35.0	35.5	36.1	36.9	36.9	37.1
Excise Taxes	5.9	6.2	6.4	5.8	4.7	4.3	4.1
All Other	5.3	5.0	4.5	4.1	3.8	3.5	3.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
MEMO: EFFECTS OF LEGISLATION							
				As a Percent of GNP			
ERTA	-1.3	-2.6	-3.9	-4.4	-5.0	-5.3	-5.6
TEFRA		0.6	1.0	1.1	1.1	1.2	1.2

NOTE: Details may not add to totals because of rounding.

ALTERNATIVE DEFICIT REDUCTION STRATEGIES

In developing a strategy for a major deficit reduction program, two general guidelines may prove helpful.

Policy Guidelines

First, sensible policy actions require a multi-year budget plan to be carried out over perhaps five years. The deficits projected for 1983 and 1984, as noted earlier, primarily reflect a sharply depressed economy.

Budget tightening for the short run could jeopardize the projected recovery. Moreover, much federal expenditure for the near term is fixed either by contract or by tacit commitment. Changing those expenditures would not only be disruptive; in many instances, it would raise, rather than lower, federal costs. For these reasons, the primary focus for deficit reduction initiatives should be on the latter part of the projection period.

Second, legislation should be enacted in 1983 to achieve a major part of the desired reduction in the deficit throughout the 1984-1988 period. Delays in correcting the structural deficit problem can contribute to uncertainty about the future of the economy, and such uncertainty can make lenders reluctant to enter into longer-term commitments. Moreover, budget changes are required this year to have even a moderate effect in later years. For example, because defense appropriations, especially for procurement of major weapons systems, spend out slowly, reductions in defense appropriations would be necessary this year in order to generate outlay savings in 1985 through 1988. Similarly, changes in the inflation adjustment provisions in Social Security and other benefit programs have cumulative effects--that is, the savings would be small at first, but later in the projection period, they would grow rapidly. Also, the longer time given for people to adjust to budgetary and tax changes, the smoother and more efficient the adjustments. Finally, enacting measures to reduce the deficit would be politically difficult in any year, but it will be especially so in the 1984 election year.

Broad Priorities Choices

In light of the need for a phased in deficit reduction program, three broad policy choices must be made.

An approximate deficit target for 1988 must be established. As noted earlier in this chapter, deficit goals ranging from 3 percent to 1 percent of GNP can be rationalized. But the choice really comes down to a matter of how high a priority is assigned to raising the prospects for capital investment in the economy. The more deficits are narrowed over the long term, the better the chances of a high-investment, low-interest-rate economy. Excessive or hasty measures to narrow deficits, however, can incur great risk of choking off a recovery, and of course, involve forgoing more government services or imposing greater burdens on taxpayers.

Whether to cut spending or raise taxes is the second choice that must be addressed once a deficit goal is established. Besides burdening taxpayers, all taxes impose efficiency costs on the economy. Higher income and payroll taxes almost surely discourage work effort and saving to some extent, and excise taxes distort economic choices. Though all these effects